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IN THE

Supreme Court of the United States

LIBERTY ELECTRIC POWER, LLC,

Petitioner,

v.

NATIONAL ENERGY & GAS TRANSMISSION, INC. (f/k/a PG&E National Energy Group, Inc.); NEGT Energy Trading Power, L.P. (f/k/a PG&E Energy Trading Power, L.P.),

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

AMICUS CURIAE BRIEF OF COMMERCIAL FINANCE ASSOCIATION IN SUPPORT OF PETITIONER AND IN SUPPORT OF REVERSAL OF THE COURT BELOW

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INTEREST OF AMICUS CURIAE

Commercial Finance Association ("CFA") respectfully submits this *amicus curiae* brief pursuant to Supreme Court Rule 37.2 in support of petitioner Liberty Electric Power, LLC ("Liberty").[1] CFA is uniquely positioned to speak to the impact that the decision of the United States Court of Appeals for the Fourth Circuit (the "Fourth Circuit") in this case will have on the market for commercial credit. CFA is the principal United States trade association for financial institutions that provide commercial financing to obligors. CFA's some 300 members include substantially all of the major and regional banks in the United States, as well as other independent lenders of all sizes. Financing provided by CFA members – currently exceeding $489 billion in outstanding loans and advances under revolving credit agreements in excess of $2 trillion per year – comprises a substantial portion of the United States credit market. Most of the obligors served by CFA members depend upon this financing for working capital to operate and grow their businesses.

There is a strong correlation between the availability and cost of credit and the creditor's evaluation of the risk of non-payment. If a creditor perceives increased risks in recouping its money,

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[1] Pursuant to Supreme Court Rule 37.6, CFA states that no persons or entities other than *amicus curiae* made any monetary contribution to the preparation or submission of this brief and that no counsel for any party authored this brief in whole or in part. *Amicus* has given the parties more than ten days' notice of its intention to file this brief and the parties have consented to the filing. Written consent letters are on file with the Clerk's Office.

that creditor may decide not to extend credit, to extend less credit, or to extend credit at a higher interest rate. One of the major ways in which creditors address the risk of non-payment and control the cost of credit is through guarantees. By taking guarantees from qualified guarantors, creditors often are willing to extend credit to obligors who otherwise might not have access to it, to increase the amount of credit otherwise available to obligors, or extend credit at a lower interest rate.

The Fourth Circuit's decision has far-reaching, troubling consequences for the value of guarantees and, therefore, will have a significant adverse impact upon the availability and cost of credit. As a result, the CFA has a strong interest in the outcome of this case and urges the Court to grant certiorari to review the Fourth Circuit's decision.

SUMMARY OF ARGUMENT

In the instant case, arbitrators awarded the creditor, Liberty, $140 million of principal plus $17 million of interest that accrued after the obligor filed for bankruptcy. Liberty first sought to collect its claim from the guarantor, which paid Liberty $140 million (the amount of the contractual limitation in the guarantee). Liberty allocated the first $17 million of this payment to post-petition interest, which is permissible under applicable state law and which accords with prevailing financial practices. As it was entitled to do, Liberty filed a claim for $140 million against the obligor's bankruptcy estate, recognizing that it could only seek recovery of the remaining $17 million of unpaid principal. The bankruptcy and district courts allowed the $140

million claim and ruled that Liberty could recover distributions of up to the outstanding $17 million.

While acknowledging that Liberty had the right to assert the $140 million claim against the estate and the right to allocate the guarantor's payment as it wished *vis-à-vis* the guarantor, the Fourth Circuit nevertheless recharacterized the remaining $17 million of principal that Liberty sought from the estate as impermissible post-petition interest. It denied Liberty any recovery on the $17 million pursuant to § 502(b)(2) of the Bankruptcy Code, substituting undefined "principles of equity" for the bargained-for terms of a guarantee and long-standing applicable law.

There is no authority permitting § 502(b)(2) to be extended to a relationship between a creditor and a guarantor. The rejection of well-established law to the contrary and the revision of clear contractual provisions in favor of undefined equitable principles injects significant uncertainty into commercial lending. This uncertainty alone will reduce the availability of credit and drive up its cost.

Moreover, while the Fourth Circuit purports to rely on equitable principles to benefit the debtor's estate, the decision in reality has no beneficial impact on debtors. Instead, it only serves to lessen the overall value of guarantees by making the order and timing of a creditor's collection efforts dispositive of whether those efforts will be successful. The inevitable consequence of the Fourth Circuit's decision is that creditors will be less inclined to accept a limited guarantee and will become more selective with respect to whom they

accept as a guarantor. Because guarantees are so critically important to commercial finance transactions as a form of third-party credit support, anything that impairs their value or utility will have an adverse impact on the availability and cost of credit and, thus, on the financing of businesses and ventures.

ARGUMENT

I. THE FOURTH CIRCUIT'S EXPANSION OF § 502(b)(2) TO THE RELATIONSHIP BETWEEN A CREDITOR AND A NONDEBTOR THIRD PARTY FINDS NO SUPPORT IN BANKRUPTCY LAW.

The majority improperly extends § 502(b)(2) of the Bankruptcy Code to interfere with the relationship between a creditor and a nondebtor third-party guarantor. In doing so, the Fourth Circuit reverses almost 100 years of well-settled law that, except where bankruptcy law requires otherwise, bankruptcy provisions should not impact relationships with nondebtor parties. *See, e.g.*, *Butner v. United States*, 440 U.S. 48 (1979); *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156 (1946); *Am. Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.*, 233 U.S. 261 (1914). The purpose of § 502(b)(2) is to preclude creditors from receiving unmatured post-petition interest from a debtor's estate. It has not been, and should never have been, applied to an independent, bargained-for contract between a creditor and a nondebtor guarantor. Yet the Fourth Circuit has effectively expanded the reach of § 502(b)(2) to preclude a creditor from receiving post-petition interest from a guarantor

notwithstanding the specific terms of their agreement. As the dissenting opinion notes, the majority "would have the bar to recovery of interest from the debtor swallow the accrual of interest on the debt across all parties liable for it." Appendix ("App.") A to Liberty Electric Power, LLC's Petition for a Writ of Certiorari ("Cert. Pet."), at 16a.

The dissent is correct that there is "nothing in the Bankruptcy Code, applicable case law, the relevant guarantee agreement, or nonbankruptcy law to support the jettisoning of basic contract law principles in favor of an expansive reading of § 502(b)(2)." App. A at 16a. Indeed, the Fourth Circuit supplants both the terms of the parties' contract and applicable non-bankruptcy law with undefined "principles of equity" in order to expunge the creditor's claim. App. at 9a. Although § 105 of the Bankruptcy Code gives the bankruptcy court certain equitable powers, the exercise of those powers must be tied to some other provision of the Bankruptcy Code. *Joubert v. ABN AMRO Mortgage Group, Inc. (In re Joubert)*, 411 F.3d 452, 455 (3d Cir. 2005); *Disch v. Rasmussen*, 417 F.3d 769 (7th Cir. 2005); *New England Dairies, Inc. v. Dairy Mart Convenience Stores, Inc. (In re Dairy Mart Convenience Stores, Inc.)*, 351 F.3d 86, 92 (2d Cir. 2003). The Fourth Circuit failed to offer any Bankruptcy Code provision to justify its "equitable" transmutation of Liberty's principal claim into a claim for post-petition interest. Rather, invoking unspecified equitable principles, the Fourth Circuit simply deemed Liberty's state law claim for unpaid principal to be one for post-petition interest, and then disallowed the interest claim under § 502(b)(2).

But the plain terms of the statute itself did not apply to Liberty's unpaid principal claim, nor do they dictate that result.

II. THE FOURTH CIRCUIT'S EXPANSION OF § 502(b)(2) TO THE RELATIONSHIP BETWEEN A CREDITOR AND A NONDEBTOR THIRD PARTY INTERJECTS UNCERTAINTY INTO LENDING RELATIONSHIPS THAT WILL ADVERSELY IMPACT THE AVAILABILITY AND COST OF CREDIT.

A. The Injection of Uncertainty Into Guarantee Transactions Harms Credit.

Although this case involves the use of undefined equitable principles to impair a guarantee, the majority's unprecedented tack creates significant uncertainty concerning the scope of a bankruptcy court's equitable powers, including its authority to rewrite contracts and agreements under the banner of equity, as well as uncertainty regarding the liability of a guarantor for post-petition interest, the validity of well-established case law, and the scope of § 502(b)(2). All of this uncertainty undercuts a creditor's ability to foresee and protect against risk and, therefore, necessarily impacts the availability and cost of credit. As the Seventh Circuit explained in *First Wisconsin Financial Corp. v. Yamaguchi*:

> Clarity is important to commercial transactions. The beneficiary of a guaranty relies on the undertaking in

> supplying credit. Unless the lender can determine the extent of its protection through objective criteria, the risk of doing business will go up, and with it the rate of interest charged for loans. Uncertainty thus injures honest, reliable debtors.

812 F.2d 370, 373 (7th Cir. 1987). The direct link between uncertainty and the cost of credit is unassailable. For example, in *In re Lifschultz Fast Freight*, a case involving the wrongful use of the equitable principle of subordination, the court observed:

> If a court wrongly subordinates a claim, other investors are sure to take heed. An investor will see that the chance she might not get her money back has gone up slightly. She will be less willing to lend or invest in the future; and the cost of credit will rise for all.

132 F.3d 339, 347 (7th Cir. 1997).

B. The Fourth Circuit's Decision Creates Significant Uncertainty for Lenders and Other Creditors.

In situations where a creditor bargained for a guaranty of principal and interest and the guarantor is unable to pay the principal debt and interest in full, either because of an express contractual limitation on the guarantor's liability as in the case at hand, or because of a *de facto* limitation resulting from the guarantor's financial inability to pay the

entire guaranteed debt in full, the Fourth Circuit ruling erroneously makes a creditor's recovery dependent upon the order and timing of the creditor's collection efforts. Had Liberty sought to recover its $140 million claim of principal against the bankruptcy estate first, and had it received a distribution of at least $17 million from the estate, Liberty presumably would have been able to collect the entire remainder of its full $157 million claim from the guarantor, the very result contemplated by the three-party transaction.

Thus, the Fourth Circuit's ruling unfairly presents the creditor with a Hobson's choice: either it (i) exercises its right to collect first from the guarantor and thereby gives up its right to collect any remaining principal from the debtor (the result in the case at hand) or (ii) looks first to the bankruptcy estate before seeking redress from the guarantor. The first alternative is unfair because it imposes a substantial financial penalty on a creditor for exercising its bargained-for right to proceed first against the guarantor. The latter alternative is unfair because it incentivizes a creditor to exhaust its collection remedy against the debtor before proceeding against the guarantor. This option has the practical effect of converting a guarantee of payment (under which the guarantor is obligated to pay as soon as the debtor fails to make a payment when due) into a much less valuable guarantee of collection (under which the guarantor is only required to pay after the creditor's legal efforts to collect from the debtor have been exhausted). Peter A. Alces, THE LAW OF SURETYSHIP AND GUARANTY § 1:7 (West 2003). In so doing, the court is not only

"jettisoning" basic contract law principles, as the dissenting opinion noted, App. A at 16a, but is rewriting contracts between creditors and nondebtor, third-party guarantors. This is prohibited for good reason:

> Courts may not convert one form of contract into the other after the fact, without raising the cost of credit or jeopardizing its availability. Unless pacts are enforced according to their terms, the institution of contract, with all the advantages private negotiation and agreement brings, is jeopardized.

Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1356-57 (7th Cir. 1990).

A creditor who chooses to go to the bankruptcy estate first will not only incur additional legal costs by participating in the debtor's bankruptcy proceeding to its conclusion, but may be forced to wait years before receiving a distribution from the estate.[2] Moreover, the creditor is exposed to the additional risk that, when it finally turns to the guarantor for payment of the remaining amount, the guarantor's financial condition will have

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[2] Under this approach, if the creditor seeks to mitigate the delay in obtaining a distribution, and to minimize legal costs, it would presumably exercise whatever leverage it has in the bankruptcy case to secure a quick distribution through liquidation instead of reorganization. Liquidation, however, may not be the best result for the debtor and its creditors. Ironically, therefore, while the Fourth Circuit's purported goal in the instant case is to aid the debtor's estate, it may actually detract from reorganizing the debtor's affairs under chapter 11.

deteriorated. Because of all of the risks and delays attendant to the second choice, it is a wholly impractical option for most creditors.

As a practical matter, a creditor is still likely to seek payment first from the guarantor. The inevitable offshoot of the Fourth Circuit's decision, however, is that creditors will refuse to accept limited guarantees, and will raise the bar as to whom may be considered to be an acceptable guarantor, a result that will have a depressing impact on the availability and cost of credit.

III. THE DECISION'S ADVERSE IMPACT ON CREDIT HAS NO COUNTERVAILING BENEFIT FOR DEBTORS' ESTATES.

By basing its decision on unspecified equitable principles, the majority presumably believes that the decision will benefit debtors or their estates. The decision's impact on the value of guarantees and on the availability and cost of credit is particularly unfortunate, however, because the perceived equitable result that is the premise of the ruling is illusory, as the ruling is cash neutral to the debtor's estate.

Assume, for the sake of illustration, that the debtor's estate is paying out a 25% bankruptcy distribution.[3] Assume further that the guarantor will enforce its right of subrogation. *See* 11 U.S.C. § 509(a); *see also* Avery Wiener Katz, *An Economic Analysis of the Guaranty Contract*, 66 U. CHI. L.

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[3] The selection of 25% is arbitrary; however, the relative results are the same regardless of the assumed distribution.

REV. 47, 60 (Winter 1999); *In re Doctors Hosp. of Hyde Park, Inc.*, 474 F.3d 421, 427 (7th Cir. 2007).[4] To assess the impact of the Fourth Circuit's ruling, it is necessary to analyze what the creditor, the debtor and the guarantor would receive or pay under the Fourth Circuit's ruling, and contrast that to what they would receive or pay under this Court's rulings and those of other circuit courts.

Under the scenario that existed prior to the Fourth Circuit's ruling, and that exists in other circuits, *see* Cert. Pet. at 12-17, Liberty first receives $17 million of interest and $123 million of principal from the guarantor to reach the contractual cap of $140 million. Even though Liberty has a $140 million claim in the bankruptcy, its potential recovery is limited to the unpaid principal of $17 million, which it then receives from the debtor's estate. The guarantor would then step into Liberty's shoes and recover a 25% distribution on Liberty's $140 million bankruptcy claim, minus the $17 million that Liberty has already received. The net effect under this scenario is that the debtor pays a total of $35 million, representing a 25% distribution on the $140 million petition-date claim.

In contrast, under the Fourth Circuit's decision, Liberty has received $140 million from the guarantor, but cannot recover the remaining $17

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[4] If the guarantor has satisfied the obligor's obligation to the creditor, the guarantor is equitably subrogated to the creditor's rights against the obligor. Katz, *supra*, at 60. If the obligor is in bankruptcy, § 509(a) of the Bankruptcy Code allows the guarantor to step into the shoes of the creditor and to assert the creditor's petition-date claim against the obligor. 11 U.S.C. § 509(a).

million of unpaid principal from the debtor because the Fourth Circuit has recharacterized it as post-petition interest. The debtor pays nothing to Liberty; however, the guarantor steps into Liberty's shoes and receives a 25% distribution from the debtor on Liberty's $140 million claim. The net effect is that the debtor has still paid $35 million, representing a 25% distribution on the $140 million petition-date claim.

This exercise exposes the fallacy of the Fourth Circuit's ruling. While Liberty is precluded from recovering from the debtor the remaining $17 million in principal it is owed, the Fourth Circuit has revised the guarantee contract with Liberty and conferred a windfall on the guarantor at the creditor's expense with no benefit to the estate. Instead of Liberty receiving the first $17 million of the amount distributed on the $140 million claim ($35 million in the example), with only the balance ($18 million in the example) distributed to the guarantor on its subrogation claim, the guarantor will now receive on its subrogation claim the full distribution ($35 million in the example), resulting in an unwarranted benefit to the guarantor of $17 million.

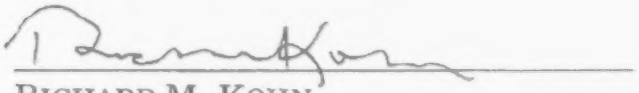
There is no basis in law or equity for the guarantor to receive this benefit at the expense of the creditor. Ironically, the transaction is a wash for the debtor's estate, which still pays a distribution on the subrogated $140 million claim allowed under § 502(b)(2). Thus, the Fourth Circuit's entire justification for substituting purported equitable principles for an appropriate result under state law and the terms of the guarantee is illusory.

CONCLUSION

The Fourth Circuit's decision is not only erroneous as a matter of law but, if left undisturbed, will also inject significant uncertainty into the credit markets, disrupt reasonable commercial expectations and reduce the availability, and increase the cost, of commercial credit. The far-reaching implications of this decision on the United States credit markets cannot be underestimated.

The petition for writ of certiorari should be granted.

Respectfully submitted,



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